

The New York Certified Public Accountant



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Managing Editor

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STATE SOCIETY ACTIVITIES

Calendar of Events

April 10—Regular Meeting of the Board of Directors.

April 10—Society Meeting. Subject: **Termination of War Contracts.** Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

May 4—Regular Meeting of the Board of Directors.

May 8—7:45 P.M. Annual Meeting of the Society. Speaker Honorable Frank C. Moore, Comptroller of the State of New York. Location: Waldorf-Astoria Hotel, Lexington Avenue and 49th Street, New York City.

Prize Essay Contest

The Committee on Publications wishes to remind the members that the 1943 Prize Essay Contest closes on May 15th. Full details are given elsewhere in this issue.

Federal Tax Ruling

Mr. Ben S. Agren, C.P.A., member of the Society, has received a ruling from the Commissioner of Internal Revenue to the effect that federal and State transfer taxes on sales of securities are deductible in computing 1943 Victory tax net income, regardless of whether the taxpayer is a trader or an investor.

Membership in the Society

For a number of years the Society's membership has grown steadily. The

Membership Committee believes that this growth will continue. The Society does not conduct any organized drives for membership, but does extend an invitation to those who have passed their C.P.A. examinations or who have received their C.P.A. certificate to become members.

The Committee suggests that each member check through the roster of members of the Society contained in the 1943 Year Book which has just been issued, to see if the name of a partner, associate, employee or friend is missing and, if so, to make every effort to secure his application for membership into the Society.

Regional Chapter Conference

The Eleventh Annual Regional Chapter Conference of the New York State Society of Certified Public Accountants will be held Thursday and Friday, September 7 and 8, 1944 at The Sagamore Hotel, Bolton Landing, Lake George, N. Y.

The conference in past years has been held in the latter part of June, but due to a number of reasons it has been decided to hold the conference in September this year.

The Sagamore Hotel is an ideal location for a conference and members are urged to plan now to attend. The program will be developed during the summer months and will be of real interest to every member.

George H. Weber

George H. Weber, a member of the Society since December 1918, passed away on November 29, 1943.

Announcement of **1944 PRIZE ESSAY CONTEST**

The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest, the essays to be on a subject of interest to the accounting profession and suitable for publication in *The New York Certified Public Accountant*. Prizes in the amount of \$150 for first prize, \$100 for second prize, and \$50 for third prize are offered.

The general rules of the contest are as follows:

All papers shall be original and the manuscript shall be typed in duplicate on 8½ x 11 stationery, double or triple space typing, and should not be more than 5000 words.

★

The name of the individual submitting the paper should not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address.

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When submitted to the judges, each manuscript will be given a key number of identification.

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Manuscripts should be forwarded to The Managing Editor of The New York Certified Public Accountant, 15 East 41st Street, New York 17, N. Y., on or before May 15, 1944. Awards will be announced as soon thereafter as possible.

★

All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant*. The decision of the judges shall be final as to what papers may be entitled to prizes.

Internal Control—From the Viewpoint of the Internal Auditor

By WILLIAM H. GARBADE

OUR meeting here tonight may prove to be an event of outstanding historical significance in the field of auditing generally. To the best of my knowledge, this is the first time that any state society of certified public accountants has met formally with The Institute of Internal Auditors to discuss the subject of Internal Auditing. Certainly in the years to come these two professional bodies cannot fail to place greater emphasis on the growing interdependence of their activities, and thus recognize the vital need for continuous exchange of ideas and crystallization of viewpoints on subjects of common interest.

During the Institute's brief two and a half years of existence, no single group of individuals has contributed more to its sound growth than our associate members, the public accountants. And today with new chapters of The Institute being organized in other sections of the country, we continue to receive unstinted support from the public accounting profession, as evidenced not only by their membership, but also by their enthusiastic participation in all of our programs.

Tonight's meeting is yet another example of this cooperative spirit. We of The Institute are indeed grateful to the Society for this opportunity to get together, and trust that you will allow us to reciprocate within the near future.

Background for Modern Internal Auditing

What is this job called "Internal Auditing?" Where does it begin

and end? To whom does it report? What are the qualifications of a good internal auditor? Should the function be limited to accounting and financial matters? Should it include methods and systems? To whom should reports be addressed? What should they contain?

These and hundreds of similar questions of specific technique could be explored at length at this type of meeting. Fortunately, however, all of you enjoy a practical working acquaintanceship with the subject, and are fully cognizant of the extreme variations in views and practices among different industries, among different companies in the same industry, and even among different branches of the same company.

For this reason our discussion tonight might draw more real interest if I focus my remarks on the fundamental factors which have caused industry to promote internal auditing to a key position in the general scheme of internal control. And I emphasize the word "promote", because you well recall the day when internal auditing, the proverbial "orphan in the storm", started with a cash account, devoted endless hour to five-cent differences, and finally ended with a bank reconciliation. And when an office manager would gladly exchange his periodic audit for a surprise visit from his mother-in-law—she was relatively tolerant.

In fact, this was during the same period when: public relations was "something" handled by a clerk in the advertising department; when management engineering was "something" performed by a draftsman;

Presented at the March 20, 1944 Meeting of The New York State Society of Certified Public Accountants.

when employee relations was "something" under the supervision of a high-grade clerk in the payroll department; when budgetary control was "something" connected with Government finance. (In other words, before Mr. Sinclair's book "Budgetary Control". Since then, industry has adopted it and government has discarded it.) (Laughter)

Yes, industrial management adopted these and many other new techniques to combat certain basic shortcomings in big business enterprise: Mass production alone was not enough. Scientific distribution and selling methods were equally vital. Gigantic mergers, amalgamations, and consolidations did not necessarily spell efficiency. Instead, they frequently made it more difficult to diagnose operating weaknesses. The real wages of labor increased, but no increase in rates could compensate for excessive unemployment. Working conditions improved, true; but the gap between policy-making management and labor widened. Similarly, the gap between stockholders and policy-making management continued to increase.

In a somewhat general way we all know the parts played by public accounting, public relations, management engineering, and budgetary control in correcting certain of these weaknesses. Now let's turn to Internal Auditing, its unique characteristics, accomplishments, and opportunities.

Internal Auditing's Unique Characteristics and Opportunities

With its origin in the accounting field, internal auditing derives its distinctive position in the sphere of managerial control from a series of peculiar characteristics which are not common to other staff departments within the organization or to public accounting staffs. In other words, these qualities make internal auditing a "natural", if you will, for

use by top management in establishing and maintaining enlightened internal control.

Prejudice

The first of these inherent characteristics is prejudice, or partiality, bias, or loyalty—whichever happens to be your viewpoint. Compared with the public accountant, the internal auditor is partial toward the company under audit because his client is his employer. His monthly pay envelope and his future career both depend upon the long-term success of his employer. Moreover, every day of the year is devoted to the same single job.

Clearly, this form of bias limits the scope of internal auditing—prevents the profession from truly representing the interests of stockholders, for example. Yet, from the managerial point of view, this drawback becomes a high-grade asset.

Picture, if you will, two different audits of accounts receivable in the branch office of a wholesale food distributor. The first—that of the external auditor—reports balances in an excellent statistical position, controls functioning in strict accordance with the textbooks, and collections improving materially. The only criticism concerns several violations of established credit limits.

A second audit covering the same identical conditions, but performed by the internal staff, calls management's attention to the following facts:

Notwithstanding a substantial increase in all classes of business, there occurred a decline of 5% in credit sales to civilian accounts which can be traced directly or indirectly to customer friction attributable to defective collection procedure. Follow-up letters frequently reached customers a few days after monthly statements, and dun letters were timed without regard to special cir-

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cumstances reported by the sales force.

At the root of the problem was found an insufficient and cumbersome posting procedure which delayed mailing of statements to customers. Unwilling to face an impaired statistical position caused by this condition, the collection department released follow-up letters on normal schedule. You know the answer.

As for violations of established credit limits, the internal auditors found that no upward revisions had been made to take into account wartime increases in minimum quantities delivered in the firm's trucking equipment.

Obviously, the internal auditors in this case performed a real managerial service, and corrective measures were taken before the examination was concluded.

The external auditors, equally as thorough, and equally as truthful, quite naturally regarded it beyond their field to investigate the causes for, and the end results of, what appeared to be simply an "aggressive" collection policy. Thus, the employee attitude in audits usually carries with it a strong desire and direct incentive to explore all phases of a problem, regardless of whether it has any immediate bearing on the financial reports.

Company Training

The next important distinguishing characteristic of internal auditing is a background of company training. To the extent that most companies draw upon their own organization for from 50% to 100% of their internal auditors, it is second nature for these men to make all examinations in the light of company policies, standards, and objectives. To general management this is of primary interest and importance.

The degree of civilization of a community may be measured by its rules of conduct, including laws, regulations, and customs. The same holds true for corporate enterprise. All phases of a concern's business life are influenced and regulated by its own distinctive conventions, known to businessmen as principles of operation, general policies, programs, plans, procedures, rules, regulations, and traditions. Many of these are written and available to all employees affected by them. Others are simply "handed down" orally from generation to generation and accepted as gospel by everyone in the company. In scope they range all the way from observance of Memorial Day as a holiday to financing through debt versus equity.

In a highly decentralized organization structure, divisional or branch management is authorized to conduct most of its affairs within broad limits without reference to the top-most management structure (the executive committee, for example). Yet governing the activities of each division, there are major policies which are intended to establish the general character, the basic objectives, and the broad pattern of operation, a constitution and bill-of-rights, if you will. Further down on the organization ladder, the policy becomes a procedure, and the procedure is translated into job analysis. But they are all predicated on, and in support of, the general plan of operation.

No phase of managerial control is more important than the maintenance of, and adherence to, a sound set of policies for all levels and all segments of operation.

The internal auditor, as a "company man", should be as familiar with managerial policies and their application as he is with his own chart of accounts. Consequently, every assignment carries with it the obvious duty to investigate devia-

tions from policy, even though there is no financial or reporting risk involved. Through this medium, management is assured that serious departures from prescribed methods are being corrected—either through improvement in operation or, what is frequently more important, improvement in policies.

For purposes of illustration, let's take the case of the internal auditor in a metal-processing plant. During the course of his physical verification of fuel supplies and analysis of fuel consumption, he finds that a certain grade of heavy fuel oil is maintained at a temperature of 160° F. before pumping to the boiler. From his experience in other plants, the auditor knows that this grade of oil will pump satisfactorily at 120° F. but a check, on the other hand, shows that there is no departure from local instructions. Full investigation subsequently discloses that the present arrangement of steam coils, dating from 1932, is faulty, and that heat is wasted throughout every winter. Correction in earlier years was not economically feasible for the company in view of the low level of fuel oil prices, and the project was subsequently lost sight of with changes in personnel. Under present-day levels of fuel costs and scarcity of supply, however, the work will be rushed to completion at a substantial saving to the company and also to the war effort.

Other critical aspects of the policy and procedural review center about the company's compliance with contract terms, and Government regulations. Except for certain exceptional and highly technical cases, the company-trained auditor can and should test adherence to all contract provisions, with particular reference to such items as:

1. Delivery dates and penalty or bonus payments.

2. Specifications of finished products.
3. Inspection methods.

Where the firm's output eventually finds its way to the armed forces, this type of examination is even more essential. I need only refer in passing to the irreparable damage which might have been avoided by several war contractors recently if their internal auditing function had embraced some kind of product inspection.

In the realm of Government regulations generally, the company-trained examiner is almost indispensable—especially under present conditions. An internal audit of prices billed to customers, for example, now includes check for compliance with instructions intended to interpret four or five major laws such as the Robinson-Patman Act, in addition to the customary verification with company price schedules. The same is true of wages, taxes, employments, and inventories. True enough, the internal auditor may sidestep these responsibilities, but only at the risk of serious embarrassment to management.

Objectivity and Independence

It has frequently been claimed and often demonstrated that appointment to the Supreme Court is a sure cure for partisanship. The reason, of course, is simple. With no axe to grind and no retaliation to fear, the individual finds himself in an atmosphere conducive to perfect justice. Without even hinting at any analogy between the two functions, somewhat the same type of change should occur in an individual with his appointment to the internal auditing staff in any large organization. For the first time in his career with the company he is no longer responsible for a set pattern of line operation and accountability. For the first time he is in a position to appraise

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an individual or operation without regard to "what the boss thinks about it". For the first time he enjoys a perspective of his company which portrays the forest instead of the trees. This perspective, a knowledge of the concern, independence, and imaginative ability, are just the ingredients which management requires for comprehensive audit reports and many other types of special investigations.

Unfortunately, however, these qualities of objectivity and independence of routine do not just "happen", nor do they automatically perpetuate themselves with a firm. Just the opposite, in fact, is true. In a typical company where the general auditor reports to the controller, there is the age-old tendency to transfer to the auditing department almost any accounting routine in which an audit disclosed weaknesses. The attitude is taken, "if the auditors are so well qualified, let them do it".

Within the past two weeks my attention was drawn to a national firm whose internal auditing department had taken over complete responsibility for the corporation's taxes, including preparation and filing of returns. It all seemed to happen quite naturally several years ago following a routine audit, and subsequently a detailed investigation which properly disclosed the need for complete reorganization of tax work. The auditor who supervised the study was eventually chosen to manage the new tax department, but he remained under the direct supervision of the general auditor. You know the result. Tax problems took over the department's administration with an accompanying serious deterioration in quality of audits. Today the company has an excellent tax department, but no internal auditing department.

Although there is no unanimity of opinion on the subject, it is my belief that many of the best internal

auditors gradually lose some of their objectivity, perspective, and enthusiasm when they stay on this type of work for indefinite periods. There is a particularly noticeable tendency toward lack of understanding for the "operating" viewpoint after an individual has been freed from operating problems for some time. Planned turnover through promotion and transfer from auditing work on a staggered basis is one logical solution to this problem. It is also a certain guarantee against stagnancy.

Mobility

The last natural characteristic of internal auditing which I plan to review this evening is its independence of organization lines and mobility. Under normal conditions, the internal auditing staff is the only group in a company whose regular assignments require access to every part of the company's activities. During the course of a year, every branch, every department, every plant, and every layer of management, from the labor foreman to the president, has had contact with internal auditors. Above all, these relationships are on a man-to-man basis without regard to salary or rank, and thereby encourage frank, unbiased discussions.

It is primarily for this reason that the internal auditing department should constitute an ideal clearing house for the dissemination of new ideas. In spite of all the routine channels provided for inter-divisional or inter-departmental flow of information concerning the "building of a better mousetrap", seldom does a good audit fail to publicize—to the proper authorities—a new idea which might be used profitably somewhere else in the company. Conversely, seldom does a good audit fail to leave with local personnel some profitable suggestions for more efficient operation from a cost standpoint.

In precisely the same way, inter-

nal auditors are perhaps the only individuals who can regularly test the accuracy of interpretations placed on managerial policies by the "man on the job". Within some companies, instructions are rewritten two or three times before reaching the individual who is being "instructed". Since they are usually familiar with the "thinking behind the policy", internal auditors are ideally qualified to appraise the ultimate procedures, instructions, and their practical results in the field.

When the present manpower emergency has subsided, internal auditing is likely to become, for all large establishments, a training ground for junior and senior executives. It is destined to fulfill a key role in the general plan for rehabilitation and replacement of promising men returning from military service. Largely because of its scope and mobility, the auditing department can offer a planned program for "on the spot" study and review of the entire organization during a two- or three-year period. Simultaneously, the "trainee" will be making valuable contributions to the company's future operating and organization program, and assisting management to place him in the proper permanent job.

Internal Auditing's Future

Throughout the course of this discussion I have purposely steered clear of the routine audit functions as applied to strict accounting and financial matters. Although the importance of this field cannot be overemphasized, I would much prefer to leave that phase of the subject for Mr. Sinclair who is really qualified to speak the language of the certified public accountant.

The principal thought that I should like to leave with this group

this evening is that the internal auditing department enjoys certain unique qualities such as loyalty, independence, company training, objectivity, and perspective which qualify it as the key managerial instrument of overall internal control—if you like, the "seeing eye" of top management. In so far as the word "auditing" limits its scope to traditional accounting subjects, the term "internal auditing" is already obsolete. To modern management the title means "internal control" in its broadest sense, including many types of special investigation for all layers of management.

Gradually, farsighted internal auditing departments are demonstrating their ability to shift their viewpoint from the past to the future. Reviews, examinations, and investigations of previous trends and transactions are meaningless unless they assist in planning for a better future. Along with this change, look for industry to continue to broaden the scope of internal auditing into the field of internal management engineering, a subject which has a vital bearing on the entire system of internal control.

In conclusion, may I simply call your attention to the fact that there is still a committee in Washington headed by a smooth-spoken gentleman from Missouri by the name of Harry S. Truman. He operates on the principle that, if we get the facts, the conclusions will take care of themselves; and he's been able to get some facts about suppliers before their own management found them—much to the embarrassment of all American industry. Looking toward the future, industry must choose now—immediately—between the *voluntary* use of modern internal control to find its own facts, or the *involuntary* acceptance of Government agencies as their sources of information.

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Internal Control—From the Viewpoint of the Public Accountant

By PRIOR SINCLAIR, C.P.A.

IF industry's war production programs are to be fully met, a basic necessity is a well devised system of internal control and constant attention to its performance by a capable and ample staff of internal auditors. Such a system provides, among other things, that information regarding materials, their location, character and availability, and also information regarding material requirements, is promptly ascertainable and is reliable. Failure in this respect alone and the resultant failure to provide for an adequate and properly-timed flow of material into production and assembly will do more than any other one thing to upset and make impossible performance in accordance with delivery schedules, a most vital necessity for the success of the war effort.

I believe it will be helpful in the development of the subject to present a brief resume of the circumstances which lead to the inclusion, in the short form of report, of the statement to the effect that the system of internal control and the accounting procedures of the company had been reviewed by the independent public accountant.

While references to the subject of internal control will be found in the many technical books dealing with accounting and published over the years, I think it would better serve our purpose if we traced the history of this subject as it appears in publications by the Federal Reserve Board, the research bulletins of our professional societies, and in the regulations of the Securities and Exchange Commission.

An early instance of reference to this subject is found in the bulletin issued by the Federal Reserve Board in April, 1917, in which there appears, under the caption of "General Instructions for a Balance Sheet Audit of a Manufacturing or a Merchandising Concern," the following paragraph:

"The scope of a balance sheet audit for a fiscal year or other operating period of an industrial or mercantile corporation or firm comprises a verification of the assets and liabilities, a general examination of the profit and loss account, and, incidental thereto, an examination of the essential features of the accounting."

There is no doubt in my mind that the reference in that paragraph to an examination of the essential features of the accounting contemplated that the independent public accountant would, by test and inquiry satisfy himself that the procedures of internal control were adequate and that they were being effectively performed.

We find this subject dealt with in a later Federal Reserve Board bulletin issued in May, 1929, entitled "Verification of Financial Statements" which, in commenting on the scope of the work of independent public accountants, states that:

"The extent of the verification will be determined by the conditions in each concern. In some cases the auditor may find it necessary to verify a substantial portion or all of the transactions recorded upon the books. In others,

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where the system of internal check is good, tests only may suffice. The responsibility for the extent of the verification must be assumed by the auditor."

It is interesting at this point to note that, while the general instructions made reference to internal control, nevertheless the suggested form of auditor's report contained no reference to this company function.

Later, in or about the year 1932, a committee representing the accounting profession in cooperation with stock exchanges, undertook further consideration of the responsibilities of the public accountant and the content of the independent public auditor's report, then more generally known as the auditor's certificate. The study and inquiry had as one of its main purposes the objective of bringing to the public a more complete understanding of the significance of accounts, their value and their unavoidable limitations.

The studies of the committee continued for over a year and the nature of the inquiry and the conclusions reached are ably presented in a pamphlet published by the American Institute of Accountants in January, 1934, entitled "Correspondence between the Special Committee on Cooperation with Stock Exchanges and the Committee on Stock List of the New York Stock Exchange."

The pamphlet refers to the matter of internal control in the following words:

"Your committee (the committee representing the New York Stock Exchange) is satisfied that the detailed scrutiny and verification of the cash transactions of large companies can most efficiently and economically be performed by permanent employees of the corporation, particularly today, when bookkeeping is to so large an extent done by mechanical

means, and that it would involve unwarranted expense to transfer such work to independent auditors or to require them to duplicate the work of the internal organization. Your committee, however, feels that the auditors should assume a definite responsibility for satisfying themselves that the system of internal check provides adequate safeguards and should protect the company against any defalcation of major importance. Unless so satisfied, the auditors should make clear representations on this point—in the first place, to the management and, in default of action by the management, to the shareholders. Your committee also suggests that this limitation on the scope of the audit, though an entirely proper one, should be specifically mentioned in the common form of audit report."

The report also contains a suggested form of accountants' report, which became known as the "Short-Form Report" and, in due course, was largely in use.

The proposed form of report contained a brief description of the character and scope of the examination performed. I now read that part of the certificate to which I refer:

"In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions."

While the foregoing language does not include the words "system of internal control," the references therein to accounting records, other supporting evidence, information

obtained from officers and employees, and the general review of the accounting methods, all tend to indicate that the effectiveness of internal control was of importance to the public accountant in reaching his opinion upon the reliability of the financial statements.

Continued consideration of the responsibilities of the independent public accountant led to the publication in the year 1936 by the American Institute of Accountants of a bulletin entitled "Examination of Financial Statements by Independent Public Accountants".

That bulletin, in an effort to develop a more complete public understanding of the work of public accountants, its scope, limitations and the area of its responsibilities, stated as follows:

"An important factor to be considered by an accountant in formulating his program is the nature and extent of the internal check and control in the organization under examination. The more extensive a company's system of accounting and internal control, the less extensive will be the detailed checking necessary. For example, a plant addition in a large-sized company may be limited to the amount of a specific appropriation made by the administration; the work may be undertaken by a construction department, the funds may be disbursed by the treasurer's department and the whole be subject to review in the comptroller's department when the necessary entries are made. In such a case the accountant is obviously warranted in making a much less extensive check of the details than in a small company where the manager orders the expenditure and the bookkeeper makes the entries.

"The term 'internal check and control' is used to describe those measures and methods adopted

within the organization itself to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping. The safeguards will cover such matters as the handling of incoming mail and remittances, the proceeds of cash sales, the preparation and payment of payrolls and the disbursement of funds generally, and the receipt and shipment of goods. These safeguards will frequently take the form of a definite segregation of duties or the utilization of mechanical devices. For example, the cashier will have no part in the entering of customers' accounts or the preparation of their statements, and neither he nor the ledger-keeper will have authority to issue or approve credits to customers; the clerk recording the labor time and preparing the payroll will not be permitted to handle the funds; approval and entry of vouchers will be made by others than the disbursing officer; and stock records and inventory control will be kept independent of both the shipping and receiving departments. The extent to which these and other measures are practicable will naturally vary with the size of the organization and the personnel employed.

"The detailed scrutiny and check of cash transactions of large companies can be performed more economically by permanent company employees. Where such a check is provided, the accountant will modify his program accordingly. Where the internal check and control are necessarily limited or severely restricted, the examination to be made will be more comprehensive in character; but no examination should be regarded as taking the place of sound measures of internal check and control, except in cases where the organization is so small as to make ade-

quate internal check impracticable. Except in the case of a small business, the cost of a detailed audit would be prohibitive, and the problem is to develop a general system of examination under which reasonably adequate safeguards may be secured at a cost that will be within the limits of a prudent economy. In the large majority of cases a detailed audit is not justified and the accountant relies on various test-checks of the records. The extent of the examination and of these test-checks is essentially a matter of judgment which must be exercised by the accountant, based on his experience, on his knowledge of the individual situation and on the extent of the internal check and control."

It is interesting to note from the foregoing that, while the text of the bulletin elaborated upon the importance of internal control in its relation to determining the scope of an examination by independent public accountants, the suggested form of certificate is identical with that previously presented and does not contain a direct reference to internal control.

In 1939 a committee of this Society was appointed to review certain phases of auditing procedures and related matters. This committee worked in cooperation with other accounting societies, national and local, representatives of credit grantors and the Securities and Exchange Commission.

The report of this committee was adopted at a meeting of this Society on May 22, 1939, and published under that date. The report dealt at length with other auditing matters, and the committee had the following to say in relation to internal control:

"The discovery of defalcations has not been a primary objective of an examination incident to the issuance of financial statements

accompanied by a report and opinion of an independent certified public accountant, although such discovery has frequently resulted. In a well-organized concern, the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to satisfy himself that the system of internal check and control is adequate and sufficiently effective to justify reliance thereon."

This report also contained a suggested short form of independent certified public accountant's report, which I will read in part:

"We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company, and have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate."

Thus, for the first time in 1939 the recognized standard short-form report contained a direct reference to the system of internal control. The general use of that form of report has continued to the present.

The principal accounting regulation of the Securities and Exchange Commission, known as Regulation S-X, provides in Rule 2.02(b) that:

"In determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff. The

Internal Control—From the Viewpoint of the Public Accountant

accountant shall review the accounting procedures followed by the person or persons whose statements are certified and by appropriate measures shall satisfy himself that such accounting procedures are in fact being followed."

The foregoing review will evidence and emphasize that the introduction of the new language in the auditor's report did not bring about any change in the public auditor's responsibilities in respect of internal control, but merely brought into the auditor's report additional language in expression of a long-established condition. However, the additional language did serve to publicize the fact that the public accountant is entitled to rely in part upon methods of internal control after establishing that, within the requirements of a balance sheet audit, such methods are in effective operation.

Through the years since 1917 a tremendous growth has taken place in both the size and complexity of business and industrial activities, and in the corporate organizations through which they are conducted. One effect of this growth has been to bring to the forefront the importance of adequate methods of internal control and the relation of the internal auditor to the effective functioning thereof. At the same time the importance to the independent public accountant of this phase of corporate activity became more thoroughly recognized and understood.

The primary responsibility for adequate methods of internal control rests with the comptroller, or other official of the corporation responsible for the accounting. It is also the responsibility of such accounting official to see that the established methods are properly functioning. The internal auditor operates within the corporate organization, recently more frequent-

ly independent of the comptroller's department, and responsible direct to management. The internal auditor, among other things, undertakes to check that the methods and procedures of internal control instituted by the comptroller's department are being effectively performed. While the internal auditor, in conjunction with management, performs many functions bearing more directly upon operations and directed toward the reduction of costs or the improvement of operating efficiency, all of which serve management as a guide to the determination of operating policies, the primary concern of the public accountant in the work of the internal auditors is in relation to that part of his activity which has to do with the accounts of the corporation and which have a direct bearing upon the problem of maintaining such accuracy in the accounts that statements prepared therefrom may be of a reliable character.

Having now prescribed the three separate areas in responsibility of the comptroller, the internal auditor, and the public accountants, we may now proceed to discuss how the public accountant may discharge his share of such responsibility.

The extent of the review of a company's accounting methods and systems of internal check and control and manner of making them should be adapted to the conditions of the client's business and organization. The review of the accounting methods and procedures has in mind two objectives: (1) to judge whether the procedures and internal auditing actually being followed by the client are such that we may fairly rely upon them and consequently do less testings than would otherwise be necessary, and (2) to decide whether any criticisms of the accounting methods or procedures and recommendations for improvement are of a character and of sufficient mate-

riality to require the submission of a written report thereon.

The advantages of using audit programs for the guidance of staff personnel on engagements has, I believe, become generally recognized. So long as the program is not allowed to become a substitute for the judgment of the men performing the work, it is an extremely useful working accessory. In my opinion the inflexible or standard type of audit program, for obvious reasons, is not as desirable as the programs designed to recognize the circumstances of each particular engagement. Basically the approach to a review of a system of internal control and of accounting procedures and the examination of the accounts themselves are similar, in that in both phases of the auditor's work he essentially is endeavoring to establish to his satisfaction that the facts or conditions are what they are represented to be by the client. He approaches both problems in a similar way: that is, by reviewing or testing, to an appropriate extent, evidence in support of the representations of the client. Because of the basic similarity in fundamentals it has, I believe, become recognized that some medium, which in relation to the review of internal control would be analogous to the audit program in relation to the purely audit phases of the examination, is desirable. As in the case of the audit program, considerable latitude exists in the type of record which is selected for the purpose. I believe that some firms for this purpose employ a type of check list in the form of a conveniently arranged resume of those conditions, which, in most instances, would constitute the essentials of internal control. In other cases the questionnaire type of document is used.

One of the particular advantages of both the audit program and the check list or questionnaire designed

for the review of the systems of internal control, is that each furnishes a permanent record of the work done and the field covered by inquiry and test.

It is not feasible for the public accountant independently to establish the satisfactory operation of certain phases of internal control. Generally, it is considered desirable that supporting data should accompany checks when they are submitted to the company officials for signatures so that they have the opportunity, before signing, of inspecting such data. Except perhaps in unusual cases it is not feasible for the public accountant independently to establish that in fact such data did accompany checks in the usual course of business when such checks were submitted for signature. Since it is not feasible independently to establish that certain of the phases of the internal control are operating effectively, it would seem desirable that any record of the public accountant's review of the system should distinguish between those phases and the other procedures as to which he was able to obtain corroborating evidence.

A questionnaire is helpful as a guide for evaluating the extent and effectiveness of the system of internal control. In devising this questionnaire the questions may be formulated in such manner that affirmative responses will signify satisfactory conditions and, on the contrary, negative responses may indicate weaknesses. Provision may be made in the questionnaire for indicating which of the affirmative responses were substantiated by our independent determinations and which responses were based upon representations of the client which it was not feasible to check. On any particular engagement, it is expected that the responses in the latter category will be few in number.

The questionnaire may be divided into a number of sections which ap-

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ply generally to the various asset, liability, income and expense accounts of the typical industrial concern.

In large engagements the physical separation of the questionnaire into sections permits a division of the work. In such cases the applicable section of the questionnaire would be compiled by the staff accountants who perform the corresponding audit work.

Particular attention should be given to any negative responses and it is helpful if the working papers contain concise but clear statements of the audit procedures which were adopted or extended because of the unsatisfactory conditions indicated by the negative responses. These negative responses also provide a convenient basis for the preparation of reports to clients regarding any unsatisfactory conditions which are brought to light by the review. One of the duties of the senior accountant on the engagement is to integrate the responses to the questionnaire as a whole and to consider the responses in the various sections in relation to the responses in other applicable sections. For example, responses to the section of the questionnaire on accounts payable are compared from the standpoint of consistency with responses to the question dealing with purchases and expenses. Obviously, responses should be in harmony with any relevant conditions which are disclosed by our analyses of accounts.

The public accountant, in making his review of internal control, must be just as sure of his evidence as he is in examining the accounts themselves. Original data rather than summaries or fair copies of documents should be obtained wherever possible. I must admit to a preference for the employment of the greater degree of that type of test which covers all phases of one transaction as opposed to the type in

which a large number of similar transactions are tested. In my opinion, extensive insight into a system of control may be obtained by investigating a series of related transactions. To illustrate, I believe that a review of the data in support of the various steps resulting from a requisition for materials, including the making out of the purchase order, the recording of the receipt of the material, the approval of the voucher for payment, payment therefor, and the recording of the related entries upon the books, is often more revealing than an examination of vouchers or checks for a specified time period.

To the fullest extent possible, the review of methods and procedures should be undertaken during the year as an interim investigation. However, the review of methods and procedures bearing upon specific accounts should be planned so that it will dovetail with the examination of the related accounts.

Review of accounting methods and procedures in conjunction with the examination of the accounts is accomplished by testing the actual operation of the accounting procedures and by observation of the accounting methods during the course of our examination; by making inquiries of the officers and employees; by studying the client's manuals of instruction and internal reports and records, and by analyzing data furnished by the company. In testing the operation of any accounting procedure, an appropriate number of transactions which appear to be representative are normally selected for review.

The public accountant should examine the reports of the internal auditors relating to the accounts and form an opinion of the thoroughness and dependability of their audits. Any criticisms in their reports of accounting procedures and practices should receive special attention. Not-

withstanding the fact that the internal audits are found to be thorough and dependable, we should also make our own independent review and tests of the company's accounting methods and procedures. The scope of our review and tests under these circumstances, however, need not be as extensive as would be required if there were no internal audits.

Within the limitations of the review decided upon in any year, our inquiries and tests should be searching. The vouchers examined should be scrutinized carefully and any deviation from the company's established routine of internal checking and auditing should be critically probed. Any evidence of laxity on the part of any of the client's employees or officers in matters of accounting or in the handling of monies or other assets should be noted and, if material, brought to the attention of the responsible company official and to the partner in charge of the examination.

The following questions will indicate more definitely the character of the review described. As previously stated, if the answer is in the affirmative, there is strong evidence of the existence of adequate methods; if it is in the negative, there is indication of a lack of control which further investigation may clarify or substantiate.

If cash registers, counter sales slips, collectors' receipts, etc. function as proofs of cash receipts, are such proofs checked by an employee independent of the cashier?

Is the mail opened by someone other than cashier or accounts receivable bookkeeper?

Is a record prepared by the person opening the mail of the money and checks received, and is this record given to someone other than the cashier for independent verification of the amount recorded and deposited?

Are each day's receipts deposited intact and without delay?

Does someone other than cashier make the bank deposit? If so, are the duties of that person divorced from customers' ledgers?

Is a duplicate deposit ticket, after authentication by the bank, received by an employee independent of the cashier and of the person who makes the deposits? Are such authenticated deposit tickets compared with:

- (a) Record of incoming remittances?
- (b) The cash book?

Are deposits or collection items subsequently charged back by bank (because of insufficient funds, etc.) delivered directly to an employee other than the cashier?

Are negotiable assets, other than currency, checks or drafts, in custody of an employee independent of cashier?

Is the cashier responsible for cash receipts from the time they are received in his office until they are deposited in the bank?

Are all bank accounts authorized by the board of directors?

Where branch offices make collections, are such collections deposited locally in a bank account subject only to home office withdrawal?

Is the receipt of currency, as opposed to checks or drafts, relatively insignificant?

Are unsatisfactory remittances from customers (i.e., those drawn with excessive discount deductions, etc.) under adequate control if not deposited promptly?

Is it difficult for the cashier to obtain access to the customers' ledgers and monthly statements?

On the other side of the cash book, with respect to disbursements, questions of interest are:

Are checks prenumbered?

Are voided checks preserved and filed?

Is the sequence of check numbers accounted for by whomever reconciles bank balances?

Is a check protector used?

Is a check register prepared simultaneously with the preparation of the check by mechanical device?

Are authorized signatures limited to employees who have no access to:

- (a) Accounting records?
- (b) Cash receipts?
- (c) Petty cash funds?

Is the signing or countersigning of checks in advance prohibited?

Is the practice of drawing checks to "Cash" prohibited?

Are bank reconciliations made by an employee having nothing to do with the cash procedures, including the signing of checks, and does that employee obtain the bank statements directly from the banks?

Is the practice of examining paid checks for date, name, cancellations and endorsements followed by those reconciling bank accounts?

Does supporting data accompany checks when they are submitted for signature?

Where a mechanical check signer is used, is the signature die under adequate control?

Are vouchers and supporting data effectively canceled to prevent subsequent misuse?

With respect to accounts receivable, questions of great importance in the minds of the auditor are such as these:

Are accounts independently confirmed by client's personnel with customers?

Are disputed items handled by someone other than accounts receivable bookkeepers?

Are write-offs of bad debts and adjustment credits approved by an officer?

Are credit memoranda approved by proper authority?

Is approval of credit department a prerequisite to payment of customer credit balances?

Are monthly statements sent to all customers?

Are statements independently checked to accounts and kept under control to insure their being mailed by someone other than the accounts receivable bookkeeper?

Are the duties of the accounts receivable bookkeeper separate from any cash functions?

If there is more than one accounts receivable bookkeeper, are the account sections for which they are responsible changed from time to time?

Are cash postings made simultaneously with the posting of the cash receipts records by means of a machine bookkeeping device?

Are allowances for discounts in violation of regular terms of sale specifically authorized by a responsible official?

Is the collection department independent of and does it constitute a check on accounts receivable bookkeepers?

Is the management of the credit department completely divorced from the sales department?

Is proper control exercised over bad debts after they have been written off?

With respect to the accounts payable section:

Is the voucher register (or accounts payable ledger) regularly reconciled with the general ledger control?

Are statements from vendors regularly compared with recorded liabilities?

Are adjustments of recorded accounts payable required to be supported by executive approval?

Are debit balances handled by the credit department?

The auditor's examination of accounts payable procedures dovetails necessarily with those relating to purchases and expenses, and he will make inquiries along the following lines:

Does the client have a purchasing

department? If so, is it divorced from:

- (a) The accounting function?
- (b) The receiving function?
- (c) The shipping function?

Are all purchases made on purchase orders?

Are the purchase orders prenumbered?

Does a copy of the receiving report go directly to the accounting department?

Are receiving tickets prenumbered and is a permanent record kept in the receiving department?

Are invoices checked in the accounting department against:

- (a) Purchase orders?
- (b) Receiving reports?
- (c) Inspection reports?

Is there a definite responsibility for checking invoices as to:

- (a) Prices?
- (b) Extensions?
- (c) Freight charges?

Are vouchers prepared for all purchase and expense items?

Are accounting distributions or classifications established by responsible employees?

Are vouchers for purchases and expenses examined by a responsible officer or employee to ascertain completeness of attachments and the various required approvals?

In considering the effect of wartime activities upon the problem of

internal control, it will be evident that the fundamental principles of internal control have not been changed by wartime conditions. The problems have multiplied greatly, both in character and quantity. The large use of subcontractors has extended the necessity for material and other controls so that they operate both within and without the company's own plants. The increased volume of transactions, the necessary increases of personnel, largely without special skill or training, have tended to delay the recording of transactions, and it is a never-ending and difficult task to maintain satisfactory records.

In closing, it is my observation that industries operating with adequate internal controls which are subjected to constant study and review by internal auditors have performed outstandingly and contributed greatly to the success of the war production program. Industries lacking these indispensable procedures have encountered severe delays and increased costs through labor stoppages, shortages of raw and process materials and sub-assemblies, and the lack of pertinent operating information. These latter described conditions are never effectively overcome until adequate procedures of internal control and their continuous audit and review have been instituted.

Wage and Salary Stabilization . Questions and Answers

On December 9, 1943 the Society's Committee on Wartime Economic Controls conducted a technical meeting on Wage and Salary Stabilization. The meeting was confined to the answer of questions submitted by members of the Society. The panel of experts consisted of:

C. A. Pearce of the National War Labor Board
Richard H. Krieger of Prentice-Hall, Inc.
Burton A. Zorn of Proskauer, Rose, Goetz & Mendelsohn
William McDonald of Research Institute of America

Questions answered by Messrs. Pearce and Krieger were published in the January issue of the New York Certified Public Accountant. Following are the questions answered by Messrs. Zorn and McDonald.

Questions Answered by Mr. Zorn

30. Question: What constitutes an approvable plan, or a plan which does not require approval? Please consider this question for an accounting firm having about fifty employees subject to War Labor Board jurisdiction and providing the following functions: accountants, comptometer operators, stenographers and typists, file and mail clerks, switchboard operators, receptionists, secretaries, department heads. Bear in mind that in a professional firm it has generally been the practice to grant increases in varying amounts and percentages in specific cases without any fixed regularity. Each case was considered on its own merits.

Mr. Zorn: I assume that the question is about a plan under General Order 31. In the first place the wage classifications and the job classifications you stated are, I think, sufficiently definite and sufficiently descriptive to constitute proper wage and salary rate ranges. In addition to that, of course you have to have a range, a minimum and maximum, going back to October 1942, with the exception of permitted approvable increases since then.

The question, as I get it, is whether you can operate on a plan based on

past policy, or whether you must apply for approval of a plan, or whether you prefer to operate under the automatic conditions of General Order 31.

The limitation of the War Labor Board rules and regulations on what constitutes a plan without approval is in essence a plan which has been in existence, which you can establish on the basis of your past practice; and the War Labor Board has tightened that up tighter than the Treasury by requiring some written memoranda beyond your actual payroll records. Under General Order 31, the Board requires that a plan which doesn't require approval must be represented by written statements, minutes, or memoranda of the employer which were in existence or effective prior to June 30, 1943.

Now the technical problem, or the problem you have there all the time, is this: whether or not your records and memoranda are in such shape that they indicate some basis for or method of increases either with respect to the over-all amount of increase granted during any particular year as established by records in the past, or some limitation on the maximum amount which has been given in the form of merit increase, or some evidence of the fre-

quency with which increases have been given. For example, coming back to your accounting office situation, if you have had a practice over the year, or for two or three years, or any one year prior to the stabilization program, whereby you could demonstrate by written records that it was your practice to have a personnel review, every three months, six months or year, during the course of which you granted a certain number of increases from the bottom limit, if you have written evidence to indicate that, you don't have to submit a plan for approval. But it has been my experience that only one out of a hundred employers has had a sufficiently definite plan or evidence thereof, sufficient to satisfy this regulation. My advice generally has been—follow either the terms of General Order 31 which gives you considerable latitude with respect to progression or merit increases, promotions, etc., or submit an actual plan for approval and, when you submit that plan for approval, support it with the actual evidence of what you have done in the past.

Chairman: Do you want to comment on that, Mr. Pearce?

Mr. Pearce: Except that I might emphasize that even where the plan has been clearly established in writing, by written memoranda, etc., it won't be acceptable unless, as Mr. Zorn says, it contains some limitation on the amount of merit adjustments that will be granted. In other words, a plan might be established in writing but not be a plan because it gives so much discretion to the employer in terms of the amount of adjustment that might be granted as to be unacceptable from the standpoint of wage stabilization.

31. Question: May I ask a question concerning plans?

The National War Labor Board

approves a contract between a union and an employer whereby the latter was authorized to increase rates 2½¢ an hour every three months. Would that constitute a continuing plan by the employer?

Mr. Zorn: Well usually, technically, that is in the form of an approval of an actual contract, and technically the plan would be approved for the life of that contract.

Same Questioner: And would expire with the contract?

Mr. Zorn: I would say that once it had been approved you could continue to make those adjustments. Once they had been approved I don't think there would be any difficulty about continuing. But what the Board normally approves is the actual contract unless you submit it in some other form.

I would say you ran no serious risk if you continued it.

32. Question: I should like to know whether, in the case of a reincorporation of a partnership, the experience or range for increases of bonuses for the predecessor partnership or corporation may be the proper basis on which the successor might act, assuming that the latter came into existence after October, 1942?

Mr. Zorn: I would say no. Both the War Labor Board and Treasury regulations read in terms of the "employer". You could use that very effectively for the purpose of getting approval; but I wouldn't take the chance of trying to do it without approval, because this particular corporation as the employer has no background of having paid bonuses, established job classifications, etc.

33. Question: What is the penalty for an unauthorized bonus? Where does the law and regulations state it?

Mr. Zorn: Well, that is a slightly

ticklish one. I will quote from the Treasury regulations particularly and, so far as I know, there is no specific regulation or order of the War Labor Board with respect to penalties.

In the first place, a bonus is defined as part of a salary; and the Treasury regulations say that any salary increase made before the required approval of the Commissioner is obtained is, from the date of such increase, in contravention of the act. So the violation occurs at the moment you pay the unauthorized bonus.

Now, as to the penalty. The regulations go on to say, I am talking now only of the tax angle, the most serious penalty, apart from the criminal penalty—and there of course the action must be willful; if the criminal penalty is willful you are subject to a fine of \$1,000 for each offense—but the penalty most of us thinks of is the tax penalty; I have already indicated that the violation occurs at the time when the employee's improper bonus is paid. The regulations go on to say that the entire amount of salary will be disallowed for tax purposes. If construed strictly, a bonus under the Treasury and War Labor Board definitions being a constituent part of the salary, you could be penalized up to the entire amount of the man's salary from the time of payment of the improper bonus.

I think however, that is a very drastic interpretation; I don't know whether the Treasury Department would follow it but, under a very strict construction of the regulations, they could if they chose.

34. Question: Does that mean prior to the fifty-two weeks?

Mr. Zorn: Technically yes, if the bonus constitutes a part of the 1943 salary.

35. Question: There have been a number of orders and amendments

that have come out from time to time after certain acts have been taken. Regarding these orders and amendments (and I assume this would apply to the Treasury and War Labor Board) are they retroactive, or do they apply from the date of the amendment or order, as the case may be?

Mr. Zorn: It depends on what type of order you're talking about.

Let's brush one thing aside quickly. If you go to the War Labor Board either on a joint agreement with a union or for a voluntary increase or go to Treasury with request for an increase in salary, you usually make the request to have the payment retroactive back to the date of expiration of the last union agreement, the date of application or some other date. You are controlled by the rulings of the Board or Treasury on the question of retroactivity.

I think what the question has in mind primarily are the general orders. I think there are two phases to that. Let us take General Order 31 and its predecessors as one example. The old order had a limitation in it: only 50% of the employees in a particular job classification could receive increases. Now the revised order eliminates the 50% limitation and puts it in terms of an overall 5¢ an hour increase for all employees in a particular establishment.

I would say that if an employer had in effect violated old Order 31 (which in turn, was superseded by Revised Order 31), but complied with Revised Order 31, he would be in the clear.

Now on the other hand you may have situations where, under a particular order, the succeeding orders have been more drastic on the employer. There again if he complied with the order in effect at the time these things were done, even though subsequent orders became more dras-

tic, and what had been permitted under a previous order was not permissible, I would say if he complied with the existing order until the new order came in, he would be in the clear because he would be complying with the existing regulations.

36. Question: There is one observation I'd like to make with regard to the Treasury regulations issued September 4, 1943. They were made retroactive to October 2, 1942, and I am of the opinion that if any bonuses were paid after October, 1943, for the calendar year of '42 or fiscal year ending in '43, approval should be asked of the Treasury in view of the retroactive feature of the regulation.

Mr. Zorn: I think there is a misunderstanding on that, sir. The dates October 3rd or October 27th, 1942, which is the base from which the stabilization program begins, are predicated on the passage of the Act and the subsequent Executive Orders. But when you say they're retroactive to October, 1942, that isn't quite true, because there has been a prohibition on increases, except in terms of regulations, which existed all during this period and the base 1942 is simply the date from which wage stabilization begins.

37. Question: A chain store organization is composed of a parent corporation and twenty subsidiary corporations. Each subsidiary corporation operates one store and has less than eight employees. Does the rule of eight-or-less apply in a case of this sort?

Mr. Zorn: I might get into a disagreement with Mr. Pearce on that, but as I read General Order 4 (speaking now of the War Labor Board) if the corporate structure was created in good faith and not for purposes of avoiding the stabilization rules, I would say that each subsidiary is a separate employer; and if each sub-

sidary operates a single store with eight or less employees it would come under the eight-or-less rule. As that orders reads, it refers to employers who at the time, etc., employ a total of not more than eight individuals in all their plants or units (and I am defining "employer" in the normal sense). So each subsidiary is a separate employer.

On the other hand, if you have a parent operating a series of stores, there is no question that it doesn't come under the eight-or-less rule, and I think the Treasury rule is defined substantially the same: that if the corporate structure is not made for the purpose of avoiding the regulations, each subsidiary will be considered a separate employer.

38. Question: Take the case of a corporation where the stockholders form a partnership to operate alongside of the corporation, so to speak, and some of the employees of the corporation are shifted to the partnership thus bringing the number of employees in both companies to eight or less. Would that come within the rule or not?

Mr. Zorn: It would depend entirely upon the good faith of that arrangement. This, I think, is the answer to it; let me read this: "if it is subsequently determined that the number of employees has been temporarily reduced by the employer or that the employer has utilized any other improper device for the sole purpose of claiming an exemption".

39. Question: A corporation having over eight employees forms a subsidiary corporation (after October 3, 1942). The subsidiary corporation employs six employees of the parent on a part-time basis. This has the effect of increased earnings of these six persons, but they have assumed new duties and responsibilities for the subsidiary corporation. Must the subsidiary obtain approval for the starting salaries of

the six persons and for subsequent increases?

Mr. Zorn: Under those circumstances I don't think the obligation is on the subsidiary to do anything provided the starting salaries paid to the employees are in line with what Mr. Pearce has indicated; namely, if they are Treasury employees, the minimum that would prevail for similar work. However, since they are getting a salary from the subsidiary and continuing to get the same salaries from the parent for doing less work (in other words, if they are working for the Subsidiary), obviously they can't be working full time for the parent. I think the obligation then would be for the parent corporation to face the problem of making an application to continue their salary and disclose all those facts. But, strictly as to the subsidiary alone, the subsidiary can pay the prevailing rate without approval.

40. Question: If an employee enters the armed service and is under contract, under a salary and a profit percentage arrangement, is approval necessary after he enters the service to continue the contract, and also to renew the contract?

Mr. Zorn: The War Labor Board has ruled that you can pay a bonus to an employee who goes into service without any approval.

Now you raise a very nice question because, under the provisions of the Selective Service Act, the employee continues to be an employee with rights of return; however, if he is doing no work for the company, in the case of the War Labor Board and in the case of the Treasury, I definitely would recommend a request for approval, since both acts are predicated on the fact that you are paying a man either a salary or a bonus based on the fact that he is actually working for you.

Mr. McDonald: I know of one Treasury case on that. The Office of Stabilization, I believe, in Atlanta, held that approval was required and, in the instance I have in mind, they gave approval for this year but only for this year. Approval for continuance of the payments in coming years would be required.

41. Question: A partnership is engaged in a non-essential activity. It employs three persons besides the partners. Upon the induction of the partner in charge of sales into the armed forces, an office employee was advanced to the position of salesman. The salary of this employee has been increased to an amount which, with commission, will approximate \$5,000 per annum. No approval for this action has been requested. Is approval required?

The same partnership proposes to give Christmas bonuses in excess of the amounts given in 1942. It also proposes to give a Christmas bonus to a new employee. Is advance approval necessary with respect to these bonuses?

Mr. Zorn: That is simple. There are three employees; is that right?

Chairman: Three employees in the partnership.

Mr. Zorn: Obviously the eight-or-less rule would apply for the salaries and bonuses and no approval would be required in either instance.

42. Question: Do employers having no plan and deciding to adopt a plan under Order 31 not requiring approval of the N. W. L. B. have to submit their new proposal to the labor organization for joint approval?

Mr. Zorn: I can answer that, I think. The question is not clear, however.

A gentleman: That means the labor union.

Mr. Zorn: I understand that phase of it, but I don't know what they want approval on.

Order 31 provides specifically that in the submission of any plan or modification of a plan, under General Order 31 (a plan for automatic increases and merit increases under General Order 31 as distinguished from a mere collective agreement where you come in and ask for a wage increase under the agreement) where there is a certified union—that is, a union either recognized or certified, in the picture, affecting those employees—you cannot submit without getting the approval of the union on it.

43. Question: Where the Treasury Department has denied approval of compensation based upon a percentage of profit because the payment this year is greater than previous years, and the employee starts suit, does this law prevent him from obtaining judgment? If it does not, what can the employer do?

Mr. Zorn: First of all, the first question you have is an interpretation of the law. If there is litigation, the courts will be called upon to interpret the Treasury regulations and, secondly, if they agree with the Treasury regulations, then as a matter of law under the general powers of the Federal Government (I'm being technical now) there is no impairment of obligation of contract prohibition against the Federal Government. The lat-

ter can pass any law within the scope of its constitutional power affecting private contracts—change them, kick them out, or do anything it chooses. So if the law is interpreted to mean that the Treasury regulation reasonably interprets the act, I think the suit would be lost.

I think there would be a fair chance, arguing against the unreasonableness of the regulations; and if he succeeded the employer and the government would be bound by the court's final judgment.

44. Question: Where salaries of officers are on an annual basis, does the October 3 date freeze the 1941 calendar-year salaries or the salaries authorized by the board of directors for the year '42 which exceed '41, but are less than any prior years?

Mr. Zorn: When were they authorized?

Same Questioner: Early in 1942.

Mr. Zorn: Then they're all right.

45. Question: What is the position of the Treasury Department in regard to severance bonuses, particularly with respect to a company going out of business where they give large bonuses to certain employees? I know approval would have to be asked; but what would the position be?

Mr. Zorn: They are subject to approval. The only types of bonus not subject to approval are the types discussed here before.

Questions Answered by Mr. McDonald

46. Question: A corporation started in business in September, 1943. It desires to establish officers' salaries. Is it necessary to obtain the authorization of the Treasury Department as to the amounts of these officers' salaries?

Mr. McDonald: Under Treasury

regulations the employer corporation is empowered to set a salary without approval for the officers. Unfortunately, neither the corporation nor the employees ever want to accept the salary rate they can institute themselves, because the Treasury is very strict—stricter than

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the War Labor Board—on establishing rates for new jobs. Under Treasury rules a rate for a new organization must be set at the minimum of the prevailing rates paid for similar jobs in similar work in the same area. Since that figure would be, first of all, almost impossible to obtain, and if obtainable would be at such a low rate that the officer would not want to take it, his best bet is to go to the Treasury and get approval for the salary he wants—or as much as he can get.

47. Question: A corporation has been in existence for several years. The officers of the corporation did not feel the necessity of accepting a salary for their services. However, during the year 1943 the corporation has sufficiently established itself so that the officers now feel they are entitled to a moderate salary for their services. Is it necessary to obtain permission to pay a reasonable salary to the officers for services rendered by them during the year 1943?

Mr. Zorn: If there were no records in existence* or no written memoranda, resolution, minutes, etc., which authorized the payment of salary to these officers, they could not receive anything until they received Treasury approval. However, under Treasury regulations (Section 1002.6), "salary" is defined not only as the amount which was received in the base year, but also as the amount which was authorized to be paid to an individual in the base year. If the employee was authorized to be paid a certain sum of money but never drew it, under that section of the regulations that salary could be begun now without approval.

48. Question: A corporation closed its books on October 31, 1942. (This also deals with the question of violations.) It paid an executive \$10,000 salary for the year ended October

31, 1942. This payment, covering the entire year, was made on the last day of the fiscal year. For the prior year it paid a salary of \$9,000 to this executive. It did not obtain approval for the increase. Assuming the increase was unauthorized, what amount will be disallowed: (a) the amount for the entire year ended October 31, 1943, or (b) the amount which applies to the period after the effective date of the salary stabilization; namely, October 2, 1942?

Mr. McDonald: I want to get those dates straight in my mind. If the date was October 31, 1942, the increase was probably made before October 3, 1942, and before the stabilization program. Any increase made prior to the stabilization program was within the company's right to make. Unless the increase was made between October 3 and October 31, there was no violation.

Chairman: No; you don't follow the question. On the last day of the year the corporation paid the salary for the entire year, part of which applied for the period prior to the existence of a wage stabilization law and part of which applied to the period subsequently. The total salary for the year was in excess of the salary for the preceding year; therefore it is assumed it was an unauthorized increase, at least in part.

Mr. McDonald: That's a little bit different. If there is no authorization for the increase, then there is a violation. It would seem to me that the violation is from October 3 to October 31. The portion of the salary for the period before that date is not controlled.

Do I have agreement?

Mr. Zorn: No, you don't. That is a very ticklish one, but I would say this:

If the salary was not fixed or determined upon until the end of the

year and the man went along to the end of the year (after October 2) without any understanding or agreement as to what his salary would be, and if it is impossible for the employer to satisfy the Treasury that a certain amount was agreed upon for his salary for the first part of the year, I think they could knock out the entire amount because the violation occurred after October 2. But again I would say they have to be pretty realistic about that and would allocate some amount prior to October 2.

49. Question: Let us take the situation of many close corporations wherein the boards of directors formally fix the salaries for the officers—let us say ten days or a month after the inception of the fiscal year—for the ensuing or current year, and that throughout the year the officers draw irregular sums against these salaries that were fixed. We will take into consideration the year indicated before—October 31, 1942—as the last date. At the close of the year a substantial part of the unpaid salary is paid—or, let us say within 2½ months after the close of the year—in order to conform to the Treasury regulations. Does the payment date have any effect whatsoever in determining whether there has been a violation?

Mr. McDonald: I think the difficulty here is largely with dates but we can agree that an agreement entered into on October 31, 1942 is meaningless as regards the stabilization program.

What I had in mind when I answered the question before, in speaking of authorization, was that if before October 2, 1942, it was agreed that there would be a salary for the coming year, that salary could be paid. If there was an authorization of salary for \$10,000 a year and throughout the year the employee drew \$7,000, in my opinion, he could be paid the \$3,000. Again I am

going back to the definition of "salary payments authorized", which I previously mentioned.

I interpret that question to mean that the fiscal year for the company ended on October 31. I still disagree with Mr. Zorn, although I will go along technically with him, that the payments made after the stabilization date are in violation. But, as a practical matter, I think that 48 weeks of the salary would be considered payment before the stabilization dates, and only that part allocated to the time between October 3 and October 31 would be considered a violation. There would be one thing which would make me hold my tongue on that and that is: If, on October 31, 1941, he had been paid \$5,000 and no authorization was made covering the next year, but during the next year he is paid \$10,000, then the \$5,000 is going to be his fixed salary. If \$10,000 was paid on October 31, 1942, everything over \$5,000 would be a violation. I think the whole year would be thrown out holding to the same logic we used before of apportioning the total payment over all weeks of the year. The Treasury would turn it down and be tough.

50. Question: On the question of eight or more employees, if a firm has nine employees including two who are in the armed services who are being paid their salaries without rendering any active service, would that firm be subject to these regulations because of the fact that they have nine?

Mr. McDonald: I wish I knew. It would seem to me that, since he is paying the men, he is paying them for personal services which is the theory of the last question; and the fact that they are not actually performing at the time would not enter into it. They are putting out money to nine people for personal services. I wouldn't do it without getting the

approval, though it may not be necessary.

Use Form NWLB-1 and see if approval is necessary on it; it might save your time.

51. Question: May an employer who has been granted authority to give an increase in salary give less than the full amount so authorized? May such employer thereafter give partial increases from time to time until the full amount authorized has been reached? In the event such procedure is not permitted, what penalty would result to the employer in pursuing such a course?

Mr. McDonald: Under a policy of the National Board issued last March, the Board established an all-or-nothing policy. If approval is obtained you have to give either the increase which is approved in full or not at all, even though it is only a permissive approval; you have to take either all of it or none of it. You could not give partial increases legally.

I know of no instance where the Board has followed it up. I also know of no instance in which the employer has not given the full increase. But whether they would hold it as a violation and, if so, of what, I don't know.

A gentleman from the Floor: That was my question. I don't think it has been fully answered. It is the Treasury Department we are particularly interested in, not the War Labor Board, because they have published their ruling on it. The Treasury Department, as far as I know, has published no ruling on it. We wanted a reaction on it.

Mr. McDonald: Since the Treasury has not published any ruling on it, I'd state as an opinion that you would not have to give the full increase that was approved. You probably could give a partial increase and gradually raise the em-

ployee's pay into the rate that was approved. That is an opinion, however, and if you go to jail for it don't blame me.

52. Question: Under what circumstances can an employer who employs thirty or less people give salary increases to persons subject to Treasury regulation?

Mr. McDonald: General Order 31 has no effect on Treasury employees except for counting the number of employees. That is, those subject to Treasury must be counted to determine whether you have more or less than thirty. No increases can be made under General Order 31 for employees subject to the Treasury.

53. Question: Before, you raised a question of bonuses and commissions in reference to corporations. I am raising the question of agreements made by proprietorships with key men employed on a basis of salary and sharing in the profits over a period of years.

Do I understand that in those cases now under the War Labor Board ruling they must be limited to the same amount they earned in dollars during the previous year, or can they receive a proportion of their profit as fixed in the contract?

Mr. McDonald: I think I caused that confusion by using the word "corporation" before, and I did so because the question used the word "corporation". The bonus rules discussed in answering the previous question affects only Treasury employees, and the order holds whether the business is a single proprietorship, a partnership, or a corporation. But, under the War Labor Board ruling, where an employee is on a percentage of profit he can be paid without approval the full amount due, provided the basis is not changed—and base and percentage and the method of computation can not be changed without approval.

54. Question: But they don't make it very clear. They cover a salesman by individual sales, where an employee like a production man not having percentage based on sales but a contract sharing in a certain percentage of profit.

Mr. McDonald: The same rules apply to percentage of profit as percentage of sales. Under War Labor Board regulations you may apply the same percentage to the total profits. Under Treasury you are limited by the amount which you paid previously.

55. Question: How do you reconcile the necessity for approval of continuance of paying men in the armed forces with the tax regula-

tions which allow the continuation of pay of men in the armed forces?

Mr. McDonald: I think their argument is that there has been a change in the duties and responsibilities of the individual and that therefore they can refuse to permit the payments to continue. If approval is obtained, you can take the tax deduction. There is no real contradiction between these two positions, although it seems that the Treasury's left hand doesn't know what its right hand is doing.

56. Question: If the bonus paid in '42 was less than for the year '41, do you need approval now if you want to pay the same bonus as you paid for '41?

Mr. McDonald: Yes.

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ACCOUNTING SERIES RELEASE NO. 48—FEBRUARY 12, 1944

Findings and opinion of the Commission in the matter of C. Cecil Bryant, 107 East Broadway, Ocala, Florida. File No. 4-42-5, Rule II(e), Rules of Practice.

OFFICIAL TEXT

Accounting—Practice and Procedure

Permanent Disqualification of Accountant from Practice before Commission

In a proceeding under Rule II (e) of Commission's Rules of Practice, where the evidence shows that the respondent, a certified public accountant, had falsely certified financial statements forming part of a registration statement filed under the Securities Act of 1933, had made no audit of registrant's affairs and had not examined its books but had accepted without question the financial statements prepared by registrant's own employee, with whom he had a practice of splitting fees in other matters and certifying other statements likewise without audit or examination; and where respondent is wholly unfamiliar with the Commission's rules concerning financial statements and the certification thereof and, after twenty years' practice, shows lack of familiarity with and has violated rules of state board of accountancy and standards of professional conduct adopted by American Institute of Accountants; held that respondent does not possess the requisite qualifications to represent others, has engaged in unethical and improper professional conduct, and should be disqualified from and permanently denied the privilege of appearing and practicing before the Commission.

Appearances

EDMUND H. WORTHY, for the Corporation Finance Division, of the Commission.

ALLEN H. GARDNER, for the respondent.

This is a proceeding under Rule II (e) of our Rules of Practice to determine whether or not the respondent C. Cecil Bryant, a certified public accountant, should be disqualified from or denied, temporarily or permanently, the privilege of appearing or practicing before this Commission.¹

The present proceeding arises from the ac-

¹ Rule II(e) provides:

"The Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter

"(1) Not to possess the requisite qualifications to represent others; or

"(2) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct."

tivities of the respondent in connection with a registration statement filed with us on January 28, 1942, by a certain corporation which will be referred to hereinafter as "the corporation." This registration statement became the subject of a stop-order proceeding instituted by us pursuant to Section 8(d) of the Securities Act of 1933. In that proceeding the respondent, who had certified to financial statements filed as part of the registration statement, was called as a witness and testified. Other witnesses included W. F. Williams, bookkeeper of the corporation, and John Kohlhepp, an accountant on our staff. After the hearing the corporation withdrew its registration statement, with our consent, and the stop-order proceeding was discontinued.

Thereafter, on the basis of the testimony of the three witnesses above named, this proceeding was instituted. A hearing was held before a trial examiner, wherein the respondent was represented by counsel. Pursuant to stipulation, the testimony mentioned above was incorporated into the record of this proceeding.

The trial examiner filed an advisory report in which he made specific findings of fact and concluded that the respondent lacks the requisite qualifications to represent others and has engaged in unethical and improper professional conduct, within the meaning of Rule II(e). He recommended that the respondent be disqualified and permanently denied the privilege of practicing as an accountant before this Commission. A copy of the trial examiner's report was duly served upon the respondent. Since no exceptions or objections to such report have been filed, and the time for filing them has long since expired, we might properly adopt the trial examiner's advisory findings as our own without further inquiry. We have, however, thought it advisable to make an independent review of the record, and on the basis of such review we are satisfied that the trial examiner's findings and conclusions are amply supported by the evidence.

In brief, the examiner found as follows:

1. The respondent has been practicing accounting in Ocala, Florida, since 1920. Until the early part of 1942 he was a member of the American Institute of Accountants.

2. Appended to the financial statements filed with the registration statement of the corporation was a certificate signed by the respondent, stating:

"I hereby certify that I have verified the foregoing balance-sheet and its supporting schedules attached, and that the same are in agreement with the books and in my opinion

The New York Certified Public Accountant

reflect the true condition of affairs as of December 31, 1941."

3. It is uncontested in the evidence, and respondent admits in his testimony, that he made no audit of the books of the corporation and that he prepared and signed the foregoing certificate without ever having seen the books. He had no knowledge of the corporation's methods of operation or of the items reflected in the financial statements to which he certified.

4. The financial statements had been prepared by Williams, who at the time was employed by the corporation as bookkeeper. Respondent knew this, and also knew that Williams was neither a certified public accountant nor a licensed public accountant. It is clearly established that Williams was in no way acting for the respondent in preparing these financial statements. Williams made no representation that he had performed an audit. Respondent made no inquiry as to the nature of the work performed by Williams.

5. Williams had previously been in the respondent's employ, and respondent seeks to explain his signing of the certificate on the ground that he had faith in Williams' work. It is clear, however, that respondent's certification under these circumstances violated not only our own rules² but also the standards of professional conduct and rules defining unethical practice for persons holding certificates under Chapter 16537, Comp. Laws of Fla. 1931, adopted by the Florida State Board of Accountancy. The certificate was false and the circumstances under which it was made establish a complete lack of independence on the part of the respondent.³

6. The financial statements covered by the aforesaid certificate contained material misstatements and misrepresentations. For example, accounts receivable shown as "not yet due" (representing the corporation's principal asset) were found to comprise items for the most part due or past due. In addition, substantial payments received by the corporation for services to be performed in future years were credited in their entirety to income when received, and the result was an overstatement of the income and surplus of the corporation. The financial statements were deficient in other respects also. Respondent admitted that he had made no inquiry regarding these matters and had no knowledge of them.

7. The record establishes a course of dealing between Williams and respondent whereby Williams, after leaving the employ of the

respondent in 1933, repeatedly performed accounting work (usually for certain municipalities in Florida) which he secured on his own initiative by placing bids therefor in the name of respondent or by causing respondent to enter such bids. When certification by a certified public accountant was required, respondent would look over Williams' work, sometimes rendering advice and counsel about it, would type the reports on his stationery, and would certify them without actually seeing the books. In return respondent would receive approximately 20 per cent of the fee, while Williams received 80 per cent thereof.

8. Respondent states that when he signed the above certificate he was, and still is, wholly unfamiliar with our rules with respect to preparation of financial statements and certification thereof. The record also discloses his unfamiliarity with the standards of professional conduct and the rules defining unethical practices promulgated by the Florida State Board of Accountancy, and the standards of professional conduct adopted by the American Institute of Accountants. It is plain that he has engaged in practice inconsistent with these rules and standards.

In view of the foregoing, we find that the respondent (a) does not possess the requisite qualifications to represent others, and (b) has engaged in unethical and improper professional conduct. He should be disqualified from, and permanently denied the privilege of, appearing and practicing before this Commission.

An appropriate order will issue.

By the Commission (Chairman Purcell and Commissioners Healy, Pike, O'Brien, and McConnaughey).

ORVAL L. DUBOIS,
Secretary

Order disqualifying accountant from practice before Commission

A proceeding having been instituted by the Commission pursuant to Rule II(e) of its Rules of Practice, to determine whether or not the respondent C. Cecil Bryant, a certified public accountant of Ocala, Florida, should be disqualified from or denied, temporarily or permanently, the privilege of appearing or practicing before the Commission;

A hearing having been held after appropriate notice, and the Commission being fully advised and having this day issued its findings and opinion herein;

On the basis of said findings and opinion, and pursuant to said rule, it is

ORDERED that C. Cecil Bryant be and hereby is disqualified from, and is permanently denied the privilege of, appearing and practicing before the Commission.

By the Commission.

ORVAL L. DUBOIS,
Secretary

² E.g., Regulation S-X, Rule 2-02.

³ Compare, e.g., *American Terminals and Transit Company*, 1 S.E.C. 701 (1936); *National Boston Montana Mines Corporation*, 2 S.E.C. 226 (1937).

Authors of Articles In This Issue



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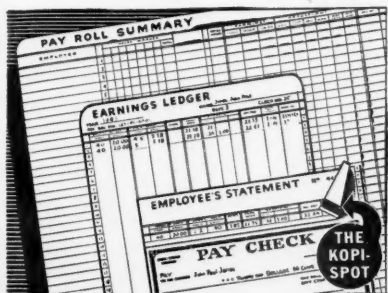
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WITHHOLD TAX		2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	
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EARNINGS		22.00	22.75	23.00	23.00	24.00	21.75	22.00	22.50	21.95	22.15	23.00	23.00	23.50	273.0
WITHHOLD TAX		2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10	2.10	1.00	1.00	1.00	
DED		1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	
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WITHHOLD TAX		7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	7.00	91.00
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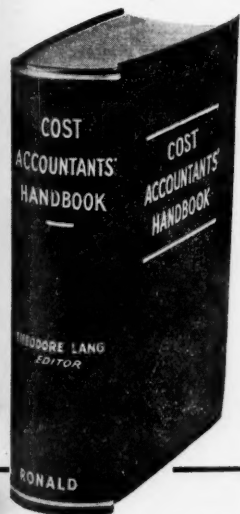
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2. Don't try to profit from the war. Don't ask more than you absolutely *must* for what you have to sell.

3. Pay no more than ceiling prices. Buy rationed goods only by exchanging stamps.

4. Pay taxes willingly.

5. Pay off your old debts—all of them.

6. If you haven't a savings account, start one.

If you have an account, put money in it—regularly. Put money in life insurance, too.

7. Buy and hold War Bonds. Don't stop at 10%. Remember—Hitler stops at nothing!

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